Wide Angle Shot: Will Hungary and Poland get (full) access to EU funds?

Raiffeisen RESEARCH

November 25, 2022 7:44 CET

Hungary and Poland are the only EU countries that have not received NGEU funds yet, for Hungary now also parts of the Cohesion Funding is at risk. Both countries are in increasingly hot discussions with the EU as economic downturn and financial markets stress add pressure to reach an agreement. Currently, EU is in a stronger negotiating position than in the past, while any well-crafted compromise can have a lot of positive aspects on EU (enlargement) agendas.

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Mastering a political compromise is not an easy ride

There has been a long-standing perceived political problem within the European Union (EU) that **some member states got diverged from the mainstream political agenda** and norms. For a long-time some countries from the Visegrad-4 had been in the focus here, e.g. Hungary or Poland. This development is often labeled as **democratic backsliding** or rule of law issues. To tackle such problems, as a political innovation a new mechanism (i.e. **the rule of law mechanism**) was created in late 2020. The European Commission (EC) has the discretionary power in initiating the procedure, and it **allows the suspension of funds** over systemic rule-of-law problems.

The EC triggered the rule of law mechanism against Hungary in April 2022, on behalf of problems with the country's public procurements and shortcomings in investigating corruption. The mechanism includes several rounds or iterations whereby the European Commission compiles its concerns while the Hungarian government gives its answers, which are analyzed and responded to, with an initially estimated timeframe of 6-9 months. The financial consequence for Hungary is the **blocking of EU cohesion funds (EUR 21bn for the 2021-2027 period)**. Moreover, Hungary's program within the **Recovery and Resilience Facility (RRF) is not accepted (EUR 5.8bn)** — apparently, the two are not fully separated from each other.

There were 18 reform measures taken by the Hungarian government with the aim of reinforcing the prevention, detection, and correction of illegalities in the use of EU funds and strengthening the independence of the judiciary system to successfully terminate the rule of law mechanism. The deadline for Hungary to prove it has implemented the necessary measures to unlock funds was 19 November. In its latest comment, the **EC acknowledged that Hungary has made good progress,** suggesting that there are **high chances for a positive decision.** Notwithstanding, the European Council proposed suspending about EUR 7.5bn funds allocated to Hungary over the rule-of-law concerns — 65 percent of funds allocated to Hungary within three cohesion programs. The proposal is backed by European Parliament.

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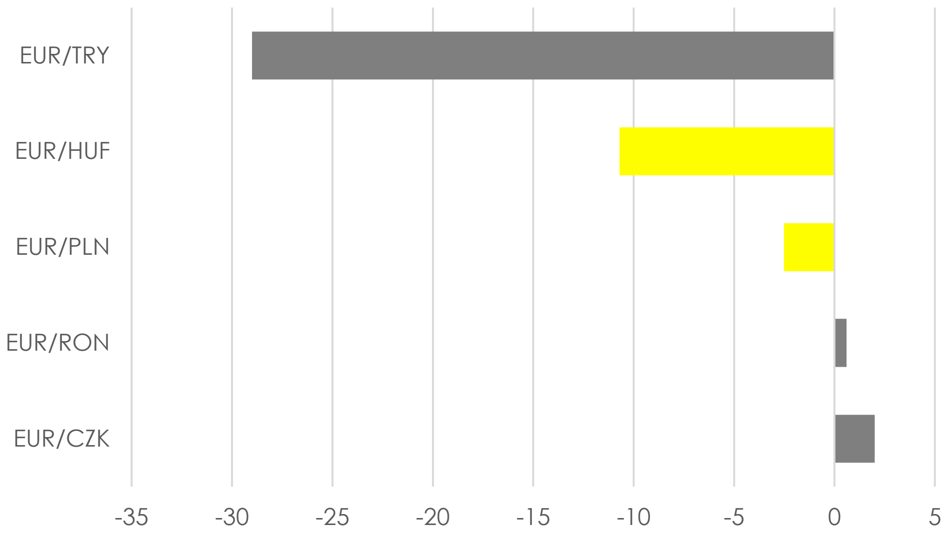
At the same time, the Hungarian government also uses its capacities to put pressure on its allies by vetoing the common EU support package to Ukraine (though it offers its own financial support bilaterally to Ukraine — proportionally the same size), vetoing the global minimum corporate tax proposal and giving no green light yet to the NATO expansion (claiming that the legislation is busy with complying the EU requirements).

As we are heading towards the end of the year, **the noise over EU-Hungarian relations is getting louder.** There is mounting time pressure though as theoretically 70 percent of the RRF funds (i.e. EUR 4.1bn) Hungary is entitled to would be lost if no deal is reached by the end of 2022. Apparently, **mastering a political compromise is not an easy ride** amidst the power struggle within the EU institutions. The next milestone is 30 November when an EC verdict over the rule of law mechanism is expected to come. This is followed by 6 Dec an ECOFIN (Economic and Financial Affairs Council) meeting with the same task. Even if the green light is given on both occasions (which is our baseline scenario), EU member states should also give their individual approval (or abstain) before the end of the year.

Currency performance YTD (%)



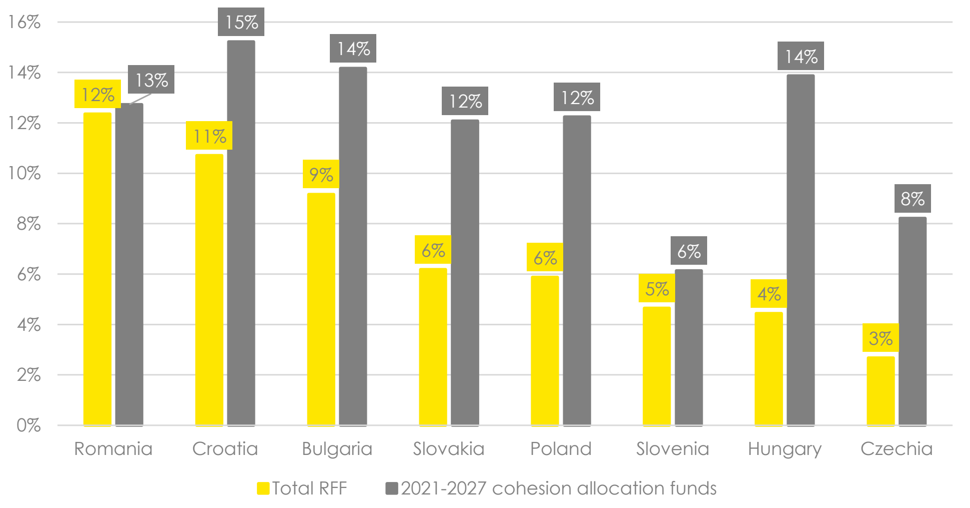
Source: Refinitiv, RBI/Raiffeisen Research

The lack of EU funds **increases the risk perception of the country, and it causes additional financial stress** in an environment of already elevated environment of risk aversion due to the Russian-Ukrainian War and the European energy crisis. The **HUF has depreciated versus the EUR over 10% in 2022**, it underperformed the peers, and the risk of a fully-fledged currency crisis got increased at an alarming speed in early October. Eventually, the National Bank of Hungary delivered an emergency 500bp interest rate hike (reference rate increased to 18%) to stabilize the HUF.

Our base case scenario (unchanged since April) is that before the end of the year the decision will arrive at **unblocking most EU money**. The most probable case would be though that besides granting full access to the RRF funds, a certain part of the EU cohesion funds will remain withhold (according to recent media reports possibly in line with the originally proposed EUR 7.5bn) and released with the condition Hungary proves its compliance to the rule of law requirements going forward.

This should eliminate a certain part of the risk premium on HUF assets (although market is already getting prepared for such an outcome) and eventually it could trigger the National Bank of Hungary to start its exit from the current extra high 18% interest rate environment. (Zoltan Török)

What's at stake?



data as % 2021 GDP
Source: EC, RBI/Raiffeisen Research

Hungary's progress adds pressure on Polish government

Also in the case of Polish struggles to receive the NGEU funds the topic has become even hotter recently with increasing expectations for an agreement. Contrary to Hungary **Polish Recovery and Resilience Plan (RRP)** has been **approved** in **June** already while the **actual release of the funds** is connected to the **implementation** of the **milestones** included in the **RRP** and **referring among others** to the **judiciary system** — the reform of which since 2015 has been the key point of tensions between Poland and EU (the independence of the judiciary in particular).

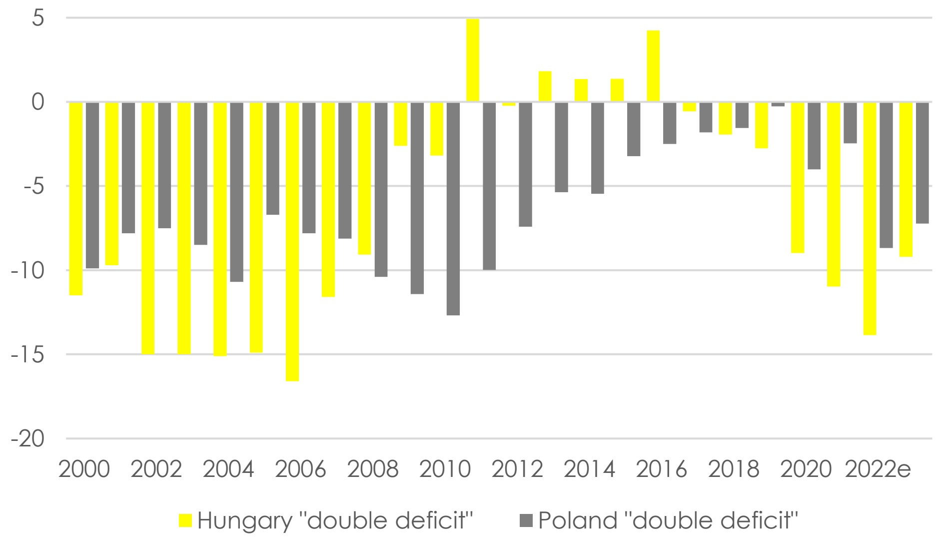
The newly appointed Minister for EU affairs Sz. Szynkowski vel Sęk declares he is determined to reach an agreement underlining that in current conditions there is no room to lose any funds to which Poland is entitled. The details of the discussions with the European Commission are unknown, however. According to Mr Szynkowski vel Sek the milestones have mostly been implemented while some responses to those milestones are the point of current discussions with the EU.

Our **baseline assumption** remains that **Poland does come to an agreement** and **receives the EU funds.** Not to forget, that **Poland** currently takes a very **active role** in **supporting neighbouring Ukraine (EU candidate)** and **Ukrainian refugees** within Poland. However, looking at the years-long discussions and what is at stake for both sides it is certain that the negotiations are tough and a negative scenario where the discussions prolong further cannot be excluded.

At the same time, the key factor behind recent more intense talks between EU and Poland is also largely political (ahead of Autumn 2023 Parliamentary elections in particular) as well as related to current market/economic developments. On the one hand, the deteriorating economic conditions and the overall global volatility do not support Polish (or any emerging market) assets, incl. the PLN. As a result, factors like the tensions with the EU and the lack of EU funds (sometimes leading to Polexit speculations) is a highly undesired development. In October Polish 10Y yields spiked to as much as 9% which shows that the Polish "green island" or the "pandemic resilience" may not hold this time. As a result, any factor that deteriorates the outlook and attractiveness of the Polish market is more risky currently. Not to mention the vicious circle here as the lack of EU funds only adds to the weakness of PLN and increases inflationary pressures which are already very high and persistent both in historical and cross-country comparison. Finally, domestic politics are of high relevance in the current developments as the lack of EU funds (especially if they were released to Hungary) is a negative factor for the support of the

Governing party which is trying to secure its third term. On the other hand, the decision-making of the governing party on the EU funds topic is stalled by a minor coalition partner led by the justice Minister who conducted the disputed judiciary reform. The agreement with the EU could therefore lead to a break within the coalition while recent comments seem to suggest that the government is indeed determined to secure the RRF funds despite this risk. (Dorota Strauch)

Hungary & Poland: Back in deficits
Sum of budget balance & C/A balance (% of GDP)



Source: national sources, RBI/Raiffeisen Research

EU in a much stronger negotiating position vis-a-vis Hungary - mind the broader spillovers

The issue of **linking EU funds** and governance or **rule of law issues**, and the current case of Hungary in particular, has **several strategic** dimensions:

- Firstly, Hungary is currently acting less than in the past from a position of economic and political strength. The currency weakness and record-high inflation are scratching the Orban (conservative) administration's "economic success model". The **external financing situation** is currently much more difficult for countries like Hungary and Poland. Both countries are currently running heavy twin deficits. In case of Hungary headline deficit numbers are close to the times before the last IMF programe (2008). Thus, the **availability of EU funds** for **emerging markets** like Hungary and Poland has again a **multiple strategic importance** to secure capital inflows and investor confidence. In this respect, it is quite rational that the EU is currently actively using this position of relative strength (compared to the situation some 12-18 months ago, characterized by manageable fiscal and current account deficits plus smooth international market access at favorable terms).
- Secondly, there is a certain **frustration** in many **Western European EU countries** that the net recipient countries of EU funds in Central and South-Eastern Europe have not achieved the hoped-for progress in the area of corruption and governance in recent years. In this respect, **EU enlargement** (for instance to include the Western Balkans, perhaps at some point Ukraine or Moldova) is **only politically feasible** if there is confidence in Western EU countries that the **EU can and will really withdraw funds** in the event of problems with the rule of law.
- Third, the EU is currently in a much stronger (bargaining) position than before the Ukraine war in terms of linking EU funds and rule of law issues. The **overall cohesion** of the **Visegrad-4 group** (Poland, Hungary, Czechia, Slovakia, possibly also including Slovenia) has **weakened** significantly. On certain EU agendas (such as relations with Russia and the sanctioning of Russia), Hungary is even acting almost in isolation,

while Poland, of course, clearly supports the current EU course towards Russia in many areas and/or even demands a tougher course together with other EU countries; Czechia, Slovakia and Slovenia are also strongly supporting a strong EU stance vis-a-vis Russia.

In light of the dimensions sketched previously it is also clear that the current dispute between the EU and Hungary is not only about this bilateral relationship, but about much more. In this respect, we think that the **EU will not be too quick to give Hungary a "blank cheque" without limits** or **conditionalities** with regard to the availability of EU funds. At the same time, however, it is equally important to find a **compromising solution** that clearly shows that EU funds and the rule of law belong together and that **positive developments** or **relative improvements** — as can be seen in Hungary at the moment — are definitely **financially worthwhile**. And thus, EU membership will be revalued to secure macro-financial stability and investor confidence. Meanwhile, the EU Parliarment (a hawkish institution when it comes to democracy and rule of law agendas) remains clearly in favor of not releasing EU funds for Hungary, while the EU Commission is possibly more in for compromising solutions. (Gunter Deuber)

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Symbol	Date	Recommendation	Company
PL	29.04.2022	Not rated	Poland

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	Column A	Column B
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Imprint

Creation time of this publication: 25/11/2022 7:44 A.M. (CET) ;
First Dissemination of this publication: 25/11/2022 7:44 A.M. (CET)

Imprint

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